

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Nakanishi Analyst: Jane Tolman Bill Number: AB 1888
Related Bills: See Legislative History Telephone: 845-6111 Introduced Date: 02-05-2004
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Medical Savings Accounts Deduction

SUMMARY

This bill would allow a tax deduction equal to the amount deposited by an employee or employer into a medical savings account (MSA).

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to assist in making medical care affordable to the residents of California.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately and apply to taxable years beginning on or after January 1, 2004.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Under prior federal law, "Archer MSAs" were trusts organized for the sole purpose of paying qualified medical expenses of the account holder, their spouse, and any dependent, as defined for income tax purposes, of the account holder. MSA's were available to individuals that were covered under a health plan that had a high deductible and was either a small-employer-sponsored health plan or a health plan for self-employed individuals.

Under prior federal law, contributions to an MSA were deductible as an adjustment to gross income if made by an eligible individual, or excludable from gross income if made by the employer of an eligible individual on behalf of that individual. This program expired on December 31, 2003.

Beginning in 2004, new federal law created health savings accounts (HSAs). HSAs are tax exempt trusts or custodial accounts created to pay for the qualified medical expenses of the account holder and his or her spouse and dependents that are subject to rules similar to those applicable to individual retirement arrangements.

Board Position:

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Department Director

Date

Gerald H. Goldberg

4/29/04

Contributions made by an eligible individual's family member are deductible by the eligible individual to the extent the contribution would be deductible if made by the individual. In addition, employer contributions to an HSA (including salary reduction contributions made through a cafeteria plan) are excludable from gross income and wages for employment tax purposes to the extent the contribution would be deductible if made by the employee. All contributions by or on behalf of an eligible individual are aggregated for purposes of the maximum annual contribution limit. The maximum annual contribution limit for an individual is \$2,600. Contributions to MSAs reduce the annual contribution limit for HSAs.

California law conforms to the expired federal MSAs but provides that the state deduction is equal to the amount allowed to that individual on the federal income tax return for the same tax year. The maximum annual contribution for an individual under the MSA is \$1,500.

California does not yet conform to the new federal HSA program.

Existing federal and state law allows individuals to deduct certain expenses, such as medical expenses (that must exceed 7.5% of adjusted gross income (AGI)), charitable contributions, interest, and taxes, as itemized deductions.

THIS BILL

This bill would allow a deduction equal to the amount deposited by an employee or employer during the taxable year in a MSA, but not to exceed \$1,500 for an individual taxpayer and \$3,000 for married filing joint or head of household taxpayer. For each taxable year the maximum dollar amount would be adjusted by the Consumer Price Index for the previous year. Any deduction claimed would be in lieu of any other deduction allowed.

This bill would define "medical savings account" as a trustee or custodial account that would be established by an individual, or jointly by an individual and his or her spouse. The MSA would be established to pay expenses incurred for medical care, including qualified long-term care and eligible long-term care premiums, of the individual establishing the account, their spouse, or their dependents.

This bill also would define several other terms including trustee or custodian, qualified long-term care service, chronically ill individual, activities of daily living, maintenance or personal care service, long-term care insurance contract, eligible long-term care premiums, and dependent.

This bill would require any amount withdrawn from the MSA and not used to pay for qualified medical expenses to be included in the income of the taxpayer, and the tax for that year would be increased by an amount equal to 10% of the payment or distribution.

This bill would require the taxpayer to provide written certification from the health care providers for the medical care provided and the charges for each of those services. The taxpayer would be required to attach the written certification to his or her income tax return if they are otherwise required to file a return.

Upon the death of the individual who established the MSA, the money in the account would be included in gross income for purposes of the decedent's final return, unless the money is deposited into a new MSA for the benefit of the surviving spouse and/or the decedent's dependent children.

This bill would require the trustee or custodian of the MSA to file an annual report concerning the status of the account. This report would contain the amount of any contributions and distributions, the name and address of the trustee or custodian, and any other information the Franchise Tax Board (FTB) may require. This report would be furnished to the individual on whose behalf the account is established, and upon request to the FTB.

IMPLEMENTATION CONSIDERATIONS

As of December 31, 2003, the federal MSA program expired and no new participants or contributions are allowed other than those individuals already participating. This bill would establish a new California MSA with different eligibility and other rules than the expired federal MSA or the new HSA program. As a result, this bill would create different tax treatment for state and federal income tax purposes, which may lead to confusion for both taxpayers and the department.

This bill would require that the taxpayer attach to their tax return written certification from the health care provider. However, due to storage costs incurred by the department, it would be more cost effective to have the taxpayer hold the certification and provide it upon request.

TECHNICAL CONSIDERATIONS

This bill states "for each taxable year beginning on or after January 1, 2003." The author's staff has acknowledged the date should be changed to January 1, 2004.

On page 6 of this bill there is a technical consideration on, line 33, the cross-reference to "paragraph (2) of subdivision (b) of Section 17267" should reference "paragraph (1)" instead.

LEGISLATIVE HISTORY

AB 2315 (Maldonado, 2003/2004) would allow the same deduction on California returns for contributions to an HSA as is allowed on the federal return. This bill is in the Assembly Revenue and Taxation Committee.

SB 1487 (McClintock, 2001/2002) would have removed the limitation of the number of taxpayers allowed to have an Archer MSA. This bill failed to pass the Senate Revenue and Taxation Committee.

AB 1631 (Pescetti, 2001/2002) would have allowed both a credit and a deduction for any contributions made to a California MSA. This bill failed to pass in the Assembly Revenue and Taxation Committee.

AB 2335 (Poochigian, 1997/98) would have made various changes to the existing MSA provisions, including a deduction for an individual's contributions to a California MSA. This bill failed passage in the Assembly Revenue and Taxation Committee.

SB 38 (Lockyer, Stats. 96, Ch. 954) conformed state law to the federal MSA law enacted in 1996.

OTHER STATES' INFORMATION

Review of *Illinois, Michigan, Massachusetts, Minnesota, and New York* income tax laws found a comparable deduction that conforms to the federal deduction for MSAs for each state except Massachusetts. These states were reviewed because of the similarities between California's economy, business entity types and tax laws.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

The net revenue impact of this bill would be a \$14 million loss annually beginning in 2004-05.

	2004-05	2005-06	2006-07
MSA contributions	\$14 million loss	\$14 million loss	\$14 million loss

Revenue Discussion

Based on federal estimates, California taxpayers would contribute \$300 million to the newly established federal HSA. The HSA has higher contribution limits than the MSA proposed in this bill, \$2,600 versus \$1,500 for individuals. It is estimated that the revenue loss would be on the order of \$14 million annually. ($\$300 \text{ million contributed to HSA} \times \$1,500/\$2,600 = 57.7\%$ $\$300,000,000 \times 57.7\% = 17,310,000 \times 8\% \text{ tax rate} = \14.4 million)

ARGUMENTS/POLICY CONCERNS

This bill would create a difference between federal and California tax law relating to MSA's and would contradict the state's current general federal conformity policy. This would increase the complexity of California tax return preparation.

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